This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 COLOMBO 002202

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD CE ECONOMICS
SUBJECT: SRI LANKA: A REFORM-MINDED 2003 BUDGET

¶1. Summary: Indicating government commitment to fiscal discipline and continued reforms, the 2003 GSL budget concentrated on improving the macro economic situation through measures to narrow the budget deficit and public debt while increasing tax revenue. The fundamental weakness of the fiscal situation remains, however; committed current expenditures absorb all of government revenue, require heavy borrowings and hold public investment below required levels. The budget foresees an improved macro economic situation and lower interest rates (stemming from a lower government deficit) together boosting private investment. In addition, the budget proposed to slightly expand tax holidays for investment and further liberalize exchange controls. Significantly, there were no populist measures. The budget was generally well received by the business community; the opposition criticized it for a lack of relief for the masses. It represents a credible first step toward fiscal stability. End Summary

----
Reign in Macro Economic fundamentals

¶2. The Minister of Finance, K N Choksy, presenting the GSL budget for FY 2003 to Parliament on November 6, said it aims to undo the defects of the past and build prosperity for the future. He said "our effort is to reform the economy in parallel with the peace process" but warned that a spectacular overnight recovery of the economy cannot be expected. He recalled that in the past, the people have judged governments and budgets by the number of flowery promises they make. He asked that this government be judged by the results it delivers.

¶3. Under the United National Front (UNF) government, the economy has already made a partial recovery from -1.3% dip in ¶2001. Growth is projected at 3% in 2002, increasing to 5.5% in ¶2003. Inflation has dropped from 14% in 2001 to about 9% in ¶2002. Considerable progress has been made in reducing the budget deficit from 10.9% of GDP in 2001 to 8.9% of GDP in 2002, which is just 0.4% off the IMF target. Deficit control, however, has come at the cost of capital expenditure. The current account deficit expanded to 4.3% of GDP in 2002 from a planned 3.4%.

Deficit to drop to 7.5% in 2003

¶4. The government commitment to strengthening macro economic fundamentals was manifested by moves to reduce government spending and increase revenue. GSL hopes a new Fiscal Management Law will ensure fiscal prudence and an Economic Management Law will help ministries track economic reforms. The 2003 budget calls for total spending (and net lending) of Rs. 438 billion ($4.5 billion), or 24.6% of GDP. Revenues are projected at Rs. 304 billion ($3.2 billion) or 17.1% of GDP, implying a budget deficit of Rs. 134 billion ($1.4 billion), or 7.5% of GDP. The contraction in the deficit from last year's levels, equivalent to about 1.4% of GDP, stems from both an increase in revenue and a reduction in current expenditure. The Government still runs a large current account deficit of 2.3% of GDP. The overall deficit is to be financed through foreign grants ($94 million), foreign borrowing ($260 million), domestic financing ($906 million) and privatization receipts ($145 million). In the medium term, the government hopes to further improve the fiscal situation by reducing the budget deficit to 5.6% of GDP by 2005.

Revenue to rise 16%; exemptions withdrawn

¶5. Revenue is forecast to increase by 16% in 2003 - a reasonable target given the projected GDP growth of 5.5%, inflation of 9% and a new, broad-based tax regime. The Value Added Tax (VAT) introduced in August 2002 and import tariffs were expanded to cover exempted goods and sectors. A 20% import surcharge will remain through 2003, while a 0.1% debit tax on bank transactions was extended to all types of bank accounts. Certain other tax exemptions were withdrawn. The government expects additional revenue of about Rs 12 billion from the expanded tax regime. Furthermore, new taxes on annual vehicle license fees, airline tickets and tourist hotels will fund the development of roads, airports and tourism. Some of these taxes have drawn criticism from affected persons and industries.

¶6. The budget announced the establishment of a revenue

authority to coordinate the functions of the various revenue collecting agencies. In addition, tax administration is to become more transparent and simplified. In order to widen the tax net, the government offered an amnesty to defaulters and non-taxpayers, with the intention of bringing them under a new tax regime from April 2003.

Expenditure to come under control

¶7. On the expenditure front, GSL expects a contraction equivalent to about 1.1% of GDP in 2003. Significantly, all of this will arise from cuts in recurrent expenditure. Public investment will rise from 4.6% of GDP in 2002 to 5.3% of GDP or Rs 95 billion ($980 million), but will remain below the 6-7% of GDP spent in 1998-2000 and below levels required for stronger economic growth. Specific expenditure control measures in the budget included strict budgetary controls, controls over defense expenditure, public administration reforms and interest savings on public debt. Otherwise the Government has little room for expenditure management, especially with debt servicing running ahead of total revenues. Interest payments will absorb 31% of government expenditure (excluding repayments), public investment (21%), defense (14%), welfare (5%), pensions (8%) and central government salaries (6%). While defense expenditure has been reduced by about 0.5% of GDP, it still remains one of the largest spending items. Total defense spending (including Police) is projected at Rs 63 billion (3.5% of GDP) in 2003 compared with 4% of GDP in 2002, 3.8% in 2001 and 5.7% in 2000. Significantly, the budget did not contain any of the populist measures typical of recent GSL budgets.

Public Debt

¶8. Due to heavy past borrowing to fund the war and unproductive programs, Sri Lanka's public debt has increased to 105% of GDP, prompting the government to accord high priority to bringing debt under control. Debt servicing at Rs 326 billion (approx $3.36 billion) is the largest expenditure item in the budget and compares to total revenues of Rs 304 billion in 2003. The main feature of the new debt management policy is to reduce short-term debt instruments by replacing them with long-term bonds at lower interest rates. A huge government overdraft from the banking sector is also being eliminated. In addition, an independent debt management office will be established in early ¶2003. These efforts, together with lower deficits, are expected to gradually reduce public debt to 91.1% of GDP by end 2005.

Reforms to continue

¶9. The budget speech reiterated the government's commitment to economic reforms covering a litany of areas - from welfare, pensions and public administration to labor, land, power and privatization. In addition, subsidies on a range of items from wheat to petroleum and electricity have been already reduced. The privatization program hopes to earn Rs 14 billion ($146 million) in 2003 through the sale of remaining Sri Lanka Telecom shares and the opening of petroleum imports to the private sector. In 2002, the government sold two sugar companies, a bunkering company and minority stakes in 6 bus companies. The sale of Sri Lanka Insurance corporation and a 15% stake in Sri Lanka Telecom are underway. Total receipts are expected at Rs 21 billion ($219 million) in 2002.

Private sector

¶10. The Finance Minister stressed the importance of stimulating growth and investment and increasing employment opportunities outside the armed forces. The government hopes that the combination of a recovering economy and a decline in public sector borrowing from domestic banks will reduce inflation and interest rates, spurring private sector activity. To boost investment, the top corporate tax band was reduced from 35% to 30%, with half of the tax savings going into a skills development fund. In addition, tax holidays were slightly increased from 3 years to 5 years for exporting companies located outside Colombo. The maximum tax holiday for large infrastructure projects was also increased from 10 to 12 years. Furthermore, joint public-private sector apex councils will boost the tourism, garments, plantation, agribusiness, fishing and jewelry industries.

¶11. The budget proposed mandatory credit ratings for financial institutions and corporate debt instruments. Exchange control liberalization will allow foreign companies to access rupee credit facilities. Various other foreign exchange liberalization measures will facilitate trade and investment: import credit facilities up to 360 days, currency conversions to settle loans, forward facilities up to 720 days and foreign

investment in debentures and government bonds.

North East rehabilitation not covered

¶12. The budget did not cover the rehabilitation of the north and east devastated by war. The Government hopes to receive aid from development partners for these activities at special donor meetings, the first of which took place in Oslo on November 25. A meeting in Tokyo in 2003 is to deal with medium term assistance for the countrywide programs in the budget.

--- ----------
Private sector welcomes the budget; opposition critical
--- ----------

¶13. Private sector analysts and the business community have praised the budget for its commitment to fiscal discipline and reforms. But they have also pressed for practical measures to implement new proposals and ensure accountability. Tax experts and businessmen also commended tax administration proposals aimed at simplifying the system. But they worry that expanded taxation will lead to inflation and affect export competitiveness. One of the most controversial has been the extension of the VAT to the banking system, which analysts fear could lead to increased interest costs. Another proposal to charge a 15% tax on inward remittances was withdrawn due to adverse effects on remittances of unskilled Sri Lankan workers in the Middle East.

¶14. The opposition has criticized the budget for a lack of relief for the working class and poor, as well as for not funding major development projects. Some opposition politicians have accused the government of simply following the dictates of the World Bank and the IMF. Key government ministers defended the budget moves, saying the country would incur more debt if the people were to be given further economic relief. The stock market reacted negatively to the budget especially due to increased taxation on the key banking sector, which accounts for 44% of Colombo market capitalization. The budget was passed in Parliament on November 14 with 129 votes for and 93 against.

Comment

¶15. This is the UNF's first full-year budget, its 2002 budget having been delayed by elections until three months into this year. It is a credible first step toward reversing the slide in fiscal discipline that Sri Lanka has suffered in recent years. But with a deficit target of 7.5% of GDP, the budget is neither ambitious nor far-reaching in its reforms. This is no surprise from a government that is pursuing a delicate peace process and faces elections any time at the will of the President. Still, if GSL sticks to this budget - or even comes close - it will be well on its way to its modest medium-term goal of fiscal stability in 2005.

Wills